

IT 96-40
Tax Type: INCOME TAX
Issue: Net Operating Loss (Section 207)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE)	
OF THE STATE OF ILLINOIS)	No.
)	
)	
v.)	FEIN:
)	
TAXPAYER)	Linda K. Cliffel
)	Administrative Law Judge,
Taxpayer)	
)	

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Daniel C. Sullivan of Sullivan & Associates, Ltd., for Al-Ways Air Freight Forwarders, Inc.; Sean P. Cullinan, Special Assistant Attorney General, for the Illinois Department of Revenue

SYNOPSIS:

This is a case involving TAXPAYER (hereinafter referred to as the "taxpayer"). The Department of Revenue issued a Notice of Deficiency on December 18, 1992 for the taxable years ending March 31, 1986 in the sum of \$18,579 plus penalties of \$15,900, and March 31, 1987 for the sum of \$5,580 plus penalties of \$4,586. The bases of the proposed deficiency are the taxpayer's failure to file income tax returns for the above-captioned periods and the disallowance of the net operating loss carrybacks. By its protest, the taxpayer states that the corporation had net operating loss carrybacks which would reduce the proposed deficiency, and that it is on this reduced figure on which penalties and interest should be calculated. In addition, the penalties should be abated due to reasonable cause. On consideration of these matters, it is recommended that the net operating loss carryback deductions be allowed, that

the penalty be sustained, and that the penalty and interest be calculated on the deficiencies before the loss deductions.

FINDINGS OF FACT:

1. The Illinois income tax return, Form 1120, for the tax year ending 3/31/86, was filed on February 15, 1993. The taxpayer carried back an Illinois net loss of \$179,143 incurred in fiscal year ending 3/31/89 to fiscal year ending 3/31/86, showing a net tax liability for 1986 of \$6,441 exclusive of interest and penalties. Taxpayer paid \$6,442, plus interest for one year, concurrently with the filing of its protest on February 6, 1993. (Tr. p. 14; Stip. 1, 5)

2. The Illinois tax return, Form 1120, for tax year ending 3/31/87, was filed on February 15, 1993. The taxpayer carried back an Illinois net operating loss of \$88,182 incurred in fiscal year ending 3/31/90, showing a 1987 tax liability of \$0, exclusive of interest and penalties. (Tr. p. 14; Stip 1, 5)

3. For tax year ending 3/31/85, the taxpayer had total payments of \$2,862. The tax was \$1,042, resulting in an overpayment of \$1,820. Of this, \$1,328 was credited to an earlier year, leaving a net overpayment of \$492 to be carried forward to 3/31/86. This was the only payment credited to or paid for the tax year ending 3/31/86. (Taxpayer Ex. No. 1; Tr. pp. 56-65)

CONCLUSIONS OF LAW:

The Department of Revenue has disallowed the use of the net operating loss carryback to the tax year ended March 31, 1986, contending that the statute of limitations to use the carryback from March 31, 1989 would have been three years, plus extensions, after the year in which the loss was incurred, or January 15, 1993. The Department relies on Section 911(g) of the IITA to support its position while the taxpayer relies on Section 911(a) to support allowance of the NOL carryback. Those sections read, in pertinent part, as follows:

§911. Limitations on Claims for Refund.

(a) In general. Except as otherwise provided in this Act:
(1) A claim for refund shall be filed not later than 3 years after the date the return was filed...or one year after the date the tax was paid, whichever is the later;...

(g) Special Period of Limitation with Respect to Net Loss Carrybacks. If the claim for refund relates to an overpayment attributable to a net loss carryback as provided by Section 207, in lieu of the 3 year period of limitation prescribed in subsection (a), the period shall be that period which ends 3 years after the time prescribed by law for filing the return (including extensions thereof) for the taxable year of the net loss which results in such carryback, or the period prescribed in subsection (c) in respect of such taxable year, whichever expires later.
35 ILCS 5/911.

The Department argues that since the returns were filed on February 15, 1993, according to subsection (g) it is more than three years from the date the 3/31/89 tax return (the year of the loss) was due, plus extensions, and therefore, the net operating loss cannot be used. (Tr. p. 14) The taxpayer argues that, pursuant to the same section of the Act, it is within the statutory period for filing a claim for refund, since that subsection only replaces the 3 year limitation of subsection (a)(1) and the 1 year limitation of subsection (a)(1) still controls.

First, although both parties cite Section 911 as supportive of their respective positions, it is questionable whether that section is even applicable. That section, in both subsections (a) and (g), refers to limitations with respect to claims for refund. No claim for refund has been filed and the taxpayer is not seeking a refund of any money. It is merely seeking a reduction of tax otherwise due, after taking into consideration a net operating loss carryback. It is filing an original return by which it is taking the net operating loss deduction. Like any deduction to which one may be entitled on an original return, the taxpayer is not precluded from taking it simply because the return has been filed late. Therefore, under this interpretation, the net operating loss carryback must be allowed as a deduction.

Assume, *arguendo*, that the deduction of the net operating loss on a late filed return is considered to be the filing of an original return plus a claim

for refund. Section 911(a) would still allow its deduction, since subsection (a) allows a claim for refund either three years after the return is filed or one year after the tax is paid. Subsection (g) states that in lieu of the three year period of limitations prescribed in subsection (a), the limitations period is three years after the time for filing the return for the year of the loss.

The statute is clear and concise. The Department attempts to interpret subsection (g) to prescribe limitations on all claims attributable to net loss carrybacks,¹ but that is simply not what the statute says. Subsection (g) changes the measurement date from the date of filing the original tax return (the year the loss is carried to) to the date of filing the return for the year of the loss. Without this provision, taxpayers would be time-barred from filing claims for refund for net operating loss carrybacks where the statute had closed for the year to which the net operating loss was being carried. The exception in subsection (g) specifically provides an exception only to the 3 year limitation of subsection (a)(1). The one year statute following payment is still available to the taxpayer.² Otherwise, the taxpayer would be denied a deduction simply because the return was filed late. The taxpayer has filed its "claim" within one year of payment and is, therefore, within the legitimate limitation period.³ The net operating loss deduction is a correct and allowable one.

The taxpayer further argues that reasonable cause existed for the failure of the taxpayer to timely file returns and pay the tax. Taxpayer asserts reasonable cause both to raise the six year statute of limitations which would

¹ "It is clear from the language in the two subsections that 911(g) controls when dealing with a claim for refund attributable to a net loss carryback." (Department Brief, p. 2)

² If the legislature had intended to provide a special period of limitation with respect to all net loss carrybacks, it could easily have omitted the reference to the 3 year period of limitation in subsection (g).

³ See also Section 6511 of the Internal Revenue Code where the special period of limitation in (d)(2) is in lieu of the 3 year limitation period of (a) only. It does not change the limitation period in (a) from 2 years from the date of payment of the tax. See also Rev. Rul. 65-281, 1965-2 CB 444.

bar assessment of the 3/31/86 tax year⁴, and to abate the Section 1005 penalties.

The evidence does not support this position. The witness, WITNESS, was employed by the corporation to assist the vice-president of finance, who had the financial responsibilities of the corporation. (The vice-president was a licensed C.P.A. and trusted family member. He had total control over all aspects of financial statement compilation and record keeping along with preparation and filing of income tax returns).

WITNESS was hired because the president of the corporation was suspicious of the vice-president's activities. (Tr. p. 47) WITNESS discovered improprieties. Bookkeeping was improper or not done at all and financial statements were provided to banks that were totally misrepresentative of the financial position of the company. (Tr. pp. 46-47) WITNESS further testified that he was not aware of any potential tax liability until the Notice of Deficiency was received. (Tr. p. 70; Taxpayer Ex. No. 2) He did not request prior returns from the Department. (Tr. p. 70)

WITNESS concluded that the taxpayer had good cause to believe that the Illinois income tax returns were filed at the same time as the federal income tax returns. (Taxpayer Ex. No. 2) However, there is no sound basis in the record for any such assumption. Since all of the tax and accounting records were in such total disarray after the vice president of finance was dismissed for improprieties, and the returns could not be found, it was unreasonable for him to conclude that all of the returns had been filed. At the very least, a simple inquiry to the Department of Revenue would have been appropriate and reasonable under the circumstances.

The assertion that WITNESS's expanded duties including keeping track of 36 companies and the receipt of 300 pieces of correspondence a day (Tr. pp. 77-78)

⁴ 35 ILCS 735/3-10 states:

In the case of a failure to file a return required by law, the tax may be assessed at any time. If the taxpayer shows that there was a reasonable cause for failure to file a return, the period shall be limited to not more than 6 years after the original date of each return required to have been filed.

does not absolve the taxpayer of a necessary standard of reasonable business procedures which should have included inquiry to the appropriate taxing authority. Although the conduct of the former vice president was certainly unfortunate, it does not excuse the taxpayer's failure to file returns or pay the tax when due.⁵ Accordingly, taxpayer has not established reasonable cause sufficient to abate the Section 1005 penalties.

Next, the taxpayer protests the imposition of the Section 804 penalty (35 ILCS 5/804) for the tax year ending 3/31/86, contending it is within exception (d)(1)(B)(ii), having paid 100% of the previous year's tax. The figures clearly do not support this argument.

For the tax year ending 3/31/85, the taxpayer had total payments of \$2,862. The tax was \$1,042, resulting in an overpayment of \$1,820. Of this, \$1,328 was credited to an earlier year, leaving a net overpayment of \$492 to be carried forward to 3/31/86. This was the only payment credited to or paid for the latter tax year. Since the tax shown on the return for 3/31/85 was \$1,042, the taxpayer would have had to pay at least that amount in estimated payments and credits to be within the exception. The net overpayment of \$492 is decidedly less than \$1,042. The fact that the taxpayer had overstated its estimated payments for the earlier year and did not apply some of the overpayment to a previous liability, thus reducing that amount available for the following year, does not relieve the taxpayer of the imposition of the penalty.

Finally, the taxpayer protests the application of interest. The net tax liability for the tax year ending 3/31/86 was \$6,441, after consideration of the net operating loss carryback. The taxpayer alleges that it is this figure on which interest and penalties should be calculated. The Department, on the other hand, contends interest is due on the tax liability before the net operating loss deduction, calculated from the due date of the original return until the

⁵ The Department of Revenue does not question the good faith of the taxpayer to remedy the situation. (See taxpayer's reply brief, p. 4) But the issue herein is reasonable cause for the period prior to the filing of the returns, not the good faith of the taxpayer once they were put on notice that the returns had not been filed.

date the return is filed. The assertion by the taxpayer and its payment of only a single year's interest has not been supported by any argument or legal citation either at the hearing or in its memoranda of law. As such, the Department's position must be acceded to on this issue.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency be disallowed as to the carryback of the net operating losses, and finalized as to the penalties and interest.

Date:

Linda K. Clifffel
Administrative Law Judge